No. 9242

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

West Coast Life Insurance Company (a corporation), Pacific National Bank of San Francisco (a national banking association), et al.,

Appellants,

vs.

Merced Irrigation District ~~and Reconstruction Finance Corporation~~,

Appellees.

BRIEF FOR APPELLANTS, FLORENCE MOORE, AMERICAN TRUST COMPANY, AS TRUSTEE, AND CROCKER FIRST NATIONAL BANK, AS TRUSTEE.

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I.

IT IS RES JUDICATA BETWEEN THE PARTIES THAT THE CONSTITUTION FORBIDS THE GRANTING OF THE RELIEF SOUGHT.

Assignments of Error:

"No. 4. The cause is res judicata." (R. 283);

"No. 83. The Court erred in failing to find that the decree dated April 12, 1937, which is referred to in the aforesaid finding, was based upon and did directly determine that the grant of powers to readjust the indebtedness referred to * * * was in excess of the powers of Congress * * *" (R. 293).

See also Nos. 71, 72, 73, 74, 75, 76, 77, 78, 79, 80, 81, 82, 84, 85, 86, 87, 88, 89, 90, 91, and 92 (R. 295-300).

We now discuss the authorities establishing the proposition that the rule of *res judicata* applies to issues of law as well as to issues of fact; that questions of constitutional law and questions of jurisdiction become *res judicata* between the parties just as other issues do; that the final determination of such questions is concluded once and for all between the parties, even though that determination is later departed from; that here, therefore, the determination, in the earlier case between the parties, that the Constitution forbids the granting of the relief here sought, is *res judicata* between the parties and so determinative of this case.

(a) The Facts Relating to the Question of Res Judicata.

On May 24, 1934, the first municipal bankruptcy act was passed (48 Stat. 798, 11 U. S. C., Secs. 301-303).

In April, 1935, petitioner herein, Merced Irrigation District, filed a petition pursuant to that act in the United States District Court, seeking confirmation of a plan identical with that here involved (R. 8; Ex. OO, p. 10).

After a trial the District Court, on March 4, 1936, made its decree confirming the plan (Ex. OO, p. 275). Pending appeal to this Court, the Supreme Court of the United States decided the case of *Ashton v. Cameron County Water Improvement District No. One* (298 U. S. 513), wherein it held that the Constitution forbids the extension of the bankruptcy power to public corporations like petitioner.

Thereupon, on March 16, 1937, the appellants herein moved this Court to dispense with the printing of the record, and for a judgment of reversal, on the authority of the *Ashton* case (Ex. OO, p. 333).

The motion was granted; and on April 12, 1937, this Court made its decree reversing the decree of the District Court and directing that Court to dismiss the cause (R. 106, 89 F.(2d) 1002).

The petitioner herein, Merced Irrigation District, then petitioned the Supreme Court of the United States for a writ of certiorari (Ex. OO), which petition was denied October 11, 1937 (302 U. S. 709). Thereafter, on July 6, 1937, pursuant to the mandate of this Court (R. 962), the District Court entered its decree dismissing the cause (R. 965).

In the meantime, the present Municipal Bankruptcy Act had been passed, on August 16, 1937, as Chapter X of the Bankruptcy Act (50 Stat. 654, 11 U. S. C., Secs. 401-404). It is now Chapter IX of the Bankruptcy Act as amended by the 75th Congress, 3rd Session (52 Stat. 840, 939-40).

This new act was upheld in *United States v. Bekins,* 304 U. S. 27, decided April 25, 1938. On June 17, 1938, the present proceeding was commenced under the new statute, seeking confirmation of the identical plan confirmation of which was sought in the previous proceeding (R. 8, 36; Ex. OO, p. 10).

The Court below rejected the argument of appellants that the matter was *res judicata* (by virtue of the former adjudication), on the ground that since the prior statute was void the Courts which decided the first case were without jurisdiction to grant the relief sought, and therefore had no power to adjudicate anything, i.e., did not even have power to decide that the Constitution forbade the granting of the relief sought. The relevant part of

the opinion of the Court below appears in the record, pages 180 to 182 (*In re Merced Irrigation Dist.*, 25 F. Supp. 981).

(b) The First and Second Statutes Are Indistinguishable.

We later show that since the prior judgment rested on the proposition that the Constitution forbids scaling down the claims of these appellants against the petitioner, under color of the bankruptcy power, the present proceeding would be determined by the prior adjudication even though the new Municipal Bankruptcy Act was substantially different from the previous one.

We now point out that so far as concerns the issue finally adjudicated in the prior proceeding, the statutes are indistinguishable. We shall not set out the two Municipal Bankruptcy Acts in this brief. Both are short, and we respectfully submit that a mere reading of the two demonstrates that no substantial change in the first is made by the second. The brief filed by Mr. George Clark, as attorney for Mary E. Morris, analyzes the two statutes in detail, and shows that they are, in every essential respect, identical.

(c) The Failure of the Supreme Court in the Bekins Case to Overrule the Ashton Case Expressly Does Not Impair the Effect of the Prior Decision Between These Parties as Res Judicata.

It is a fact that the opinion in the *Bekins* case does not in terms overrule the *Ashton* case, although a careful reading of the opinion will show, we submit, that the Court intended to be understood as doing so.

In any event, it is clear that the Court cannot reasonably be taken to have held that the second bankruptcy

act differs in any essential respect from the first. After quoting from a committee report on the second Municipal Bankruptcy Act, the Court said:

> "We are of the opinion that the Committee's points are well taken and that Chapter X. is a valid enactment. The statute is carefully drawn so as not to impinge upon the sovereignty of the State. The State retains control of its fiscal affairs. The bankruptcy power is exercised in relation to a matter normally within its province and only in a case where the action of the taxing agency in carrying out a plan of composition approved by the bankruptcy court is authorized by state law."

This language, however, cannot be taken to express the opinion that the two statutes differ, for the following reasons:

(1) The first Municipal Bankruptcy Act (Sec. 80 (k)) provided in terms that:

> "Nothing contained in this chapter shall be construed to limit or impair the power of any State to control, by legislation or otherwise, any political subdivision thereof in the exercise of its political or governmental powers, including expenditures therefor, and including the power to require the approval by any governmental agency of the State of the filing of any petition hereunder and of any plan of readjustment, and whenever there shall exist or shall hereafter be created under the law of any State any agency of such State authorized to exercise supervision or control over the fiscal affairs of all or any political subdivisions thereof, and whenever such agency has assumed such supervision or control over any political subdivision, then no petition of such political subdivision may be received hereunder un-

> less accompanied by the written approval of such agency, and no plan of readjustment shall be put into temporary effect or finally confirmed without the written approval of such agency of such plans." (11 *U. S. C.*, Sec. 303(k).)

In addition, Section 80(c) reads in part:

> "[the court] shall not, by any order or decree in the proceeding or otherwise, interfere with (a) any of the political or governmental powers of the taxing district." (11 *U. S. C.*, Sec. 303(c).)

The new statute expresses no more solicitude than the provisions just quoted, for the sovereignty of the states.

The provision of Section 80(k) just quoted, was quoted in full in the *Ashton* case (298 U. S. 513, 526).

(2) The above quotation from the opinion in the *Bekins* case might be taken to suggest that the Court believed the two statutes distinguishable on a second ground, namely, on the ground that by the second statute "the bankruptcy power is exercised in relation to a matter normally within its province". This could not have been the Court's intention, however, for two reasons: (1) Obviously if the second statute is within the province of bankruptcy, then the first one is; (2) in the first decision, i.e., the *Ashton* case, the Court assumed that the first bankruptcy act "is adequately related to the general 'subject of bankruptcy'" (298 U. S. 513, 527).

The fact is that the two statutes being in fact identical in substance, it would be unreasonable in the extreme to assume that the Supreme Court in the *Bekins* case held otherwise; and the only part of its opinion (quoted above) which might seem to distinguish the two statutes

has just been shown not to be susceptible of that construction.

(3) The only remaining circumstance which might suggest that in the *Bekins* case the Court meant to distinguish the later act from the earlier one, is the fact that the Court did not in so many words expressly overrule the *Ashton* case. This circumstance might be taken to support the inference that the Court regarded the two cases (and therefore the two statutes with which they dealt respectively) as being distinguishable. The inference would, we submit, be unsound, both because (in view of the considerations above discussed) it would contradict common sense, and because of the reasons now to be discussed.

The considerations which guide the Court in administering the doctrine of *stare decisis* are wholly different, and have no bearing on, the rules which govern application of the principle of *res judicata.* In the language of Mr. Justice Brandeis, "stare decisis is not, like the rule of res judicata, a universal and inexorable command" (285 U. S. 393, 405).

The Courts are, of course, free to overrule earlier decisions of which they disapprove. But the fact that an earlier decision is later departed from does not impair its effect as *res judicata* in any respect.

Frequently, because the Court has not finally determined that an earlier decision should be finally disapproved, it is thought preferable to explain or distinguish it, and to leave its final disposition as a precedent to a later time. For example, the Court often announces that an earlier decision *has been* overruled, referring to inter-

mediate decisions which did not do so in terms, but simply distinguished or explained away the earlier decision so far as necessary:

Morgan v. United States, 113 U. S. 476, 496;
Leisy v. Hardin, 135 U. S. 100, 118;
Brenham v. German Amer. Bank, 144 U. S. 173, 187;
Terral v. Burke, 257 U. S. 529, 533;
Lee v. Chesapeake & O. Ry., 260 U. S. 653, 659.

Decisions by a divided Court are considered to be of only limited authority, so far as concerns the rule of *stare decisis (Legal Tender Cases,* 12 Wall. 457, 553-554), although the fact that the Court was divided would not, of course, affect the force of the earlier decision as *res judicata,* in any manner or degree.

There is a considerable body of opinion that in the field of constitutional law, the doctrine of *stare decisis* is of much less force than it is in general. See the statement by Mr. Chief Justice Taney in *The Passenger Cases,* 7 How. 283, 470; and also the discussion and authorities in the dissenting opinions of Mr. Justice Brandeis in

State v. Dawson, 264 U. S. 219, 238;
Burnet v. Coronado Oil & Gas Co., 285 U. S. 393, 405, et seq.

See, also, the discussion and authorities in:

Erie R. Co. v. Tompkins, 304 U. S. 64, 77;
Warren, *Supreme Court in the U. S. History* (ed. 1928) II, 748-749;
Goodhart, "Case Law in England and America", 15 Corn. L. Q., 173, 179-180;
1 *Willoughby, Constitutional Law* (2 ed.) Sec. 44.

The rule of *res judicata,* on the other hand, is a very different matter. It has nothing to do with the policy of judicial administration embodied in the doctrine of *stare decisis.* It is a plain and unqualified rule of private law. In the language of the Supreme Court of the United States,

> "It is a fundamental principle of jurisprudence, arising from the very nature of courts of justice and the objects for which they are established, that a question of fact or of law distinctly put in issue and directly determined by a court of competent jurisdiction cannot afterwards be disputed between the same parties. *Southern Pacific Railroad v. United States,* 168 U. S. 1, 48." *(Frank v. Mangum,* 237 U. S. 309, 333.)

The considerations which lead the Courts to follow, or overrule, or distinguish, or ignore, or brush aside a precedent, simply have no relevancy when a prior decision is invoked as *res judicata* between the parties. The question whether the prior decree between these parties is *res judicata,* is in no way affected by the answer to the question whether or not the *Ashton* case is still a living precedent.

(d) The Presence of the Later Statute Does Not Impair the Earlier Decision as Res Judicata.

It has been recently settled that a decision under one statute is *res judicata* with respect to controversies under a later statute identical, or substantially so, with the prior enactment. This was established in

Tait v. Western Md. Ry. Co., 289 U. S. 620.

In a previous action, it had been held that the corporation in question had no right to deduct from gross

income an amortized proportion of the discount on sales of bonds by its predecessors. In this later case, it was held that the judgment worked an estoppel against the United States and the Collector in later litigation with the corporation, as to its right to make like deductions for subsequent years, under a later statute. The Court said in part:

> "The scope of the estoppel of a judgment depends upon whether the question arises in a subsequent action between the same parties upon the same claim or demand or upon a different claim or demand. In the former case a judgment upon the merits is an absolute bar to the subsequent action. In the latter the inquiry is whether the point or question to be determined in the later action is the same as that litigated and determined in the original action. *Cromwell v. County of Sac.,* 94 U. S. 351, 352-353; *Southern Pacific R. Co. v. United States,* 168 U. S. 1, 48; *United States v. Moser,* 266 U. S. 236, 241. Since the claim in the first suit concerned taxes for 1918 and 1919 and the demands in the present actions embraced taxes for 1920-1925, the case at bar falls within the second class. The courts below held the lawfulness of the respondent's deduction of amortized discount on the bonds of the predecessor companies was adjudicated in the earlier suit. The petitioner, admitting the question was in issue and decided in respect of the bonds issued by the second company, and denying, for reasons presently to be stated, that this is true as to the bonds of the first company, contends that as to both the decision of the Court of Appeals is erroneous, for the reason that the thing adjudged in a suit for one year's tax cannot affect the rights of the parties in an action for taxes of another year. * * *

> "This court has repeatedly applied the doctrine of *res judicata* in actions concerning state taxes, holding the parties concluded in a suit for one year's tax as to the right or question adjudicated by a former judgment respecting the tax of an earlier year. *New Orleans v. Citizens' Bank,* 167 U. S. 371; *Third National Bank v. Stone,* 174 U. S. 432; *Baldwin v. Maryland,* 179 U. S. 220; *Deposit Bank v. Frankfort,* 191 U. S. 499. Compare *United States v. Stone & Downer Co.,* 274 U. S. 225, 230-231. The public policy upon which the rule is founded has been said to apply with equal force to the sovereign's demand and the claims of private citizens."

The earlier decision referred to by the Court above had been decided under the Revenue Act of 1918, whereas the *Tait* case itself arose under the Revenue Acts of 1921 and 1924. This was held not to impair the applicability of the doctrine of *res judicata,* since the question of law decided in the first case was conclusive in the second. There, as here, it was argued that the new statute created a new right; but the legal question determined in the first case being determinative of the second, was held to conclude the parties.

Another case in which adjudication under an earlier statute was held *res judicata* under a later statute (discussed and quoted at length below) is

Gunter v. Atlantic Coast Line, 200 U. S. 273.

(e) Even Had the Second Municipal Bankruptcy Act Differed Substantially from the First, the Rule of Res Judicata Would Control.

It is, of course, settled that there are two aspects of the doctrine of *res judicata:* First, an earlier judgment

is absolutely conclusive in a later action involving the same cause of action, both as to issues actually tried and as to all matters that might have been tried. Secondly, an earlier judgment is conclusive between the parties in a later action (even though the later action is based on a wholly different cause of action) as to any issue of law or fact adjudicated in the earlier action.

See *Tait v. Western Md. Ry. Co., supra,* and the cases discussed next below.

A necessary corollary of this rule is that where an issue of fact or law previously adjudicated between the parties is, if applied, of controlling significance in a later action between them, it makes no difference that the cause of action asserted in the second case was created by a later statute.

The case now to be discussed so holds; and is, we submit, indistinguishable from the case now before this Court.

Gunter v. Atlantic Coast Line, 200 U. S. 273:

The charter of the railroad corporation involved, as amended in 1863, exempted its property from taxation. A statute of the state of incorporation (South Carolina) was nevertheless passed in 1868 attempting to subject the railroad's property to taxation. This statute was held void, as an impairment of the obligation of contract, by the Supreme Court of the United States, in 1872 (16 Wall. 244).

In 1900 the state enacted another, and quite different, statute providing for the taxation of the property of this railroad, and others with similar charters. This statute, as described by the Court (p. 289),

> "created a board to make the assessment to which it referred, limited the taxes to be imposed to ten years back, provided that the assessment made by the board should be put upon the rolls separately for each of the back years, and that there should be levied upon such assessment state and county taxes for the years to which the back assessment related. The act caused the taxes for which it provided to become a lien against the property upon which they might bear, and directed a certification of the taxes as assessed and levied to the respective county treasurers, and made it their duty to collect the same. To this end such treasurers were directed to make a demand for payment upon the company in whose name the assessment was made, or, if it was found that the property assessed was 'in the control of another company, demand shall be made of the company * * * in possession of the property.' By the act, in addition, the Attorney General was directed, if the back taxes assessed were not paid within sixty days after demand, to bring a suit in the name of the State, with the cooperation of such counsel as the counties might employ, to enforce the collection of the back taxes against the company in whose name they were assessed or against the company found in possession of the property assessed."

This proceeding was brought to enjoin the imposition of taxes under the new statute. The Court held that the matter was *res judicata* under the decision of 1872. And this notwithstanding the fact that the present attempt to tax was under the authority of a statute passed years after the decision of 1872, and related to taxes for later years, constituting therefore a completely new and different cause of action from that adjudicated in 1872. The Court said in part (p. 290):

"* * * That the issue in the case was the existence of a charter exemption from taxation in favor of the Cheraw and Darlington Railroad Company, and the consequent want of power of the State to tax the property of the railroad during the continuance of the exemption, is obvious. And that the decree rendered in the cause established the exemption embraced in the issues is also obvious. This being true, it unquestionably follows that the decree established as to the parties and their privies the very question in issue in this proceeding. * * *

"It is urged that as the taxes, the collection of which the court enjoined, were not for the same years as were the taxes with which the Pegues case was concerned, the Pegues decree was, therefore, not *res judicata,* because it related to a different cause of action. This rests upon the assumption that a decree enjoining the collection of a tax for one year can never be the thing adjudged as to the right to collect taxes of a subsequent year. But the proposition entirely disregards the fact that the decree in the Pegues case, enjoining the collection of the taxes in controversy in that case, was rested upon the ground that there was a contract protected from impairment by the Constitution of the United States which was as controlling on future taxes as it was upon the particular taxes to which the Pegues suit related."

In numerous cases the Supreme Court of the United States has held decisions on questions of law concerning taxes for a particular year to be *res judicata* in actions involving different taxes for later years. Now the levy of taxes is, of course, a purely legislative act:

Cooley on Taxation, Secs. 1012, 1013;

Heine v. Board, 19 Wall. 655;

Meriwether v. Garrett, 102 U. S. 472;
Taylor v. Secor, 92 U. S. 575.

Obviously, a levy of taxes for one year is a separate, distinct and independent legislative act from levies concerning later years. These cases, therefore, further support the proposition that the presence of a later enactment, which is the ground of the action brought, does not in any way impair the applicability of the doctrine of *res judicata* if an issue of law previously adjudicated between the parties is (as here) conclusive of the controversy. A discussion of these cases now follows:

New Orleans v. Citizens' Bank, 167 U. S. 371:

In previous actions, it had been held that the charter of the bank in question exempted it from certain taxes. This action involved similar taxes for subsequent years. The previous judgments were here held conclusive of the question whether the bank's charter created the exemption. The Court said in part, quoting with approval from other cases:

> "'Matters once determined in a court of competent jurisdiction may never again be called in question by parties or privies against objection, though the judgment may have been erroneous and liable to, and certain of, reversal in a higher court.' Bigelow Estoppel, 3d ed., Outline, pp. lxi, 29, 57, 103." (p. 398.)
>
> "'It is undoubtedly true that the taxes of each year ordinarily constitute separate and distinct rights or causes of action. But where an action is brought to recover taxes paid in one year, and an action is afterwards brought to recover for the taxes paid in a subsequent year, and the adjudication in the first is pleaded as a bar to the recovery in the second

action, the question whether the estoppel is effectual will depend upon the issues in the two actions.

"'If the right to recover and the defence thereto are based upon precisely the same ground, why litigate again the question that has been determined? In such case the very right of the matter has been determined by a court of competent jurisdiction. It is not essential that the causes of action should be the same, but it is essential the right or title should be; that is, the issues in both actions and the matter on which the estoppel depends must be the same, or substantially so." (pp. 400, 401.)

To the same effect are the numerous cases cited in *Tait v. Western Md. Ry. Co.,* 289 U. S. 620, at page 624. The *Tait* case has already been discussed and quoted at length.

Forsyth v. Hammond, 166 U. S. 506:

In this case, plaintiff's land was incorporated into a city by means of a judicial proceeding authorized by statute. Plaintiff appealed to the State Supreme Court, arguing that such incorporation was a legislative function, and could not constitutionally be accomplished in a judicial proceeding. The judgment was affirmed, however, and became final. Later plaintiff brought this proceeding to enjoin collection of a tax by the city, setting up the same contention that the judicial incorporation of her property into the city was void. The Court here held that the previous decision was *res judicata.* The Court said (p. 517):

"* * * But after an adverse decree she insisted that it was not only erroneous but void, and voluntarily commenced an action in the Supreme Court of the State to have that claim established. She

invoked the jurisdiction of that court. She summoned the city of Hammond into that forum and there challenged the decree of the Circuit Court, challenged it for error and also for lack of jurisdiction. The questions both of error and of jurisdiction were certainly judicial in their nature and questions within the undoubted cognizance of the Supreme Court. She voluntarily sought its judgment. Can she, after its decision, be heard in any other tribunal to collaterally deny the validity thereof? Does not the principle of *res judicata* apply in all its force? Having litigated a question in one competent tribunal and been defeated, can she litigate the same question in another tribunal, acting independently, and have no appellate jurisdiction? The question is not whether the judgment of the Supreme Court would be conclusive as to the question involved in another action between other parties, but whether it is not binding between the same parties in that or any other forum. The principles controlling the doctrine of *res judicata* have been so often announced, and are so universally recognized, that the citation of authorities is scarcely necessary. Though the form and causes of action be different, a decision by a court of competent jurisdiction in respect to any essential fact or question in the one action is conclusive between the parties in all subsequent actions. *Cromwell v. Sac. County,* 94 U. S. 351; *Lumber Co. v. Buchtel,* 101 U. S. 638; *Stout v. Lye,* 103 U. S. 66; *Nesbit v. Riverside Independent District,* 144 U. S. 610; *Johnson Co. v. Wharton,* 152 U. S. 252; *Last Chance Mining Co. v. Tyler Mining Co.,* 157 U. S. 683."

See, also,

Cromwell v. The County of Sac., 94 U. S. 341, 359;
Deposit Bank v. Frankfort, 191 U. S. 499.

In the next subdivision hereof, we show that the issues determined in the earlier case between the Merced Irrigation District and appellants are determinative of the present case.

(f) It is Res Judicata Between the Parties that the Constitution Forbids the Granting of the Relief Here Sought.

As shown above, in the earlier case involving the plan here involved, the decision was ground solely on the authority of *Ashton v. Cameron County Improvement District No. One,* 298 U. S. 513. The ground of the previous decision between these parties was therefore identical with the ground of the decision in the *Ashton* case; and appears unequivocally in the Supreme Court's opinion, from which we quote briefly:

> "We need not consider this Act in detail or undertake definitely to classify it. The evident intent was to authorize a federal court to require objecting creditors to accept an offer by a public corporation to compromise, scale down, or repudiate its indebtedness without the surrender of any property whatsoever. * * *
>
> "Our special concern is with the existence of the power claimed—not merely the immediate outcome of what has already been attempted. * * *
>
> "The especial purpose of all bankruptcy legislation is to interfere with the relations between the parties concerned—to change, modify or impair the obligation of their contracts. The statute before us expresses this design in plain terms. It undertakes to extend the supposed power of the Federal Government incident to bankruptcy over any embarrassed district which may apply to the court. * * *

"Neither consent nor submission by the States can enlarge the powers of Congress; none can exist except those which are granted. *United States v. Butler,* decided January 6, 1936, 297 U. S. 1. The sovereignty of the State essential to its proper functioning under the Federal Constitution cannot be surrendered; it cannot be taken away by any form of legislation. See *United States v. Constantine,* 296 U. S. 287. * * *

"* * * for a very long time this court has steadfastly adhered to the doctrine that the taxing power of Congress does not extend to the States or their political subdivisions. The same basic reasoning which leads to that conclusion, we think, requires like limitation upon the power which springs from the bankruptcy clause. *United States v. Butler, supra.*"

It thus appears beyond rational dispute that the *Ashton* case turned, not on any detailed provision in the first Municipal Bankruptcy Act but on the interpretation of the Constitution of the United States.

That instrument was unequivocally held to forbid bankruptcy legislation designed to impair the obligation of contracts of public corporations like petitioner herein. That issue, now being *res judicata* between the parties before this Court, necessarily requires the conclusion that the Court below should have dismissed the bill.

II.

THE PETITIONER OWES THE RECONSTRUCTION FINANCE CORPORATION $9,500,000.00 LESS THAN IT CLAIMS TO OWE THAT CORPORATION.

IT FOLLOWS:

(a) That Petitioner is Entirely Solvent and Able to Meet its Debts as they Mature.

(b) That the RFC is Not Affected by the Plan, and Cannot, Therefore, Effectively Consent to it.

(c) That the RFC is in a Different Class of Creditors From That Constituted by Appellants.

Assignments of Error:

"21. The Court erred in finding and holding that the Reconstruction Finance Corporation is the owner or holder of the original bond issues of the Merced Irrigation District entitled to vote on the plan of composition herein." (R. 285).

"No. 20. The Court erred in finding and holding that the Reconstruction Finance Corporation is a creditor affected by the plan." (R. 285).

See also Nos. 9, 14, 15, 19, 24, 28-31, 53.

Appellants contend that under the contract between petitioner and Reconstruction Finance Corporation (hereinafter called the RFC):

(a) The bonds of the district surrendered to the RFC by former bondholders are now held by the RFC as pledgee. The total principal amount of the bonds so held is $14,686,000 (R. 32).

(b) The beneficial ownership of these bonds is in the district, subject to the rights of the RFC, as pledgee, to realize therefrom the amount owing to the RFC if the petitioner defaults in payment.

(c) The total amount owing to the RFC is $7,570,-871.60 (R. 888), that being the total amount disbursed by the RFC.

The district, on the other hand, contends that it owes the RFC the total amount of bonds held by that corporation, i. e., $14,686,000, with unpaid interest (R. 17).

Two exhibits herein show the difference between the positions of the parties (Ex. Z, R. 886; Ex. AA, R. 887-888). These exhibits show that if the bonds held by the RFC are in fact owing by the district, the total bonded indebtedness, including unpaid interest, is $20,273,919. If, on the other hand, as appellants contend, the total amount owing to the RFC is simply the amount disbursed by that corporation, the total bonded indebtedness of the petitioner, plus the amount advanced by the RFC to take up old bonds, is in the aggregate $10,743,552.62. The parties, therefore, disagree concerning the total indebtedness of petitioner arising out of the bond issues here in question, and that difference amounts to $9,530,-366.38. As shown by Exhibit AA just mentioned, it is admitted that if appellants' contention is correct concerning the effect of the RFC contract, then the petitioner, far from being in financial difficulties, has a capital surplus of $10,743,525.62. This figure takes account of all of the assets and liabilities of petitioner, whether arising out of its bond issues or otherwise (R. 887-888). But it takes no account whatever of the value of the privately owned lands in the district.

It becomes important, therefore, to decide the controversy between the parties on this question, which actually consists of two questions:

1. What in fact is the debt owing by petitioner to the RFC as between those parties, i.e., as between the debtor and the creditor?

2. If, as appellants contend, the amount of that debt is simply the amount the RFC has disbursed, then a second question arises, namely, does the statute permit or require that the RFC be treated, for the purposes of this proceeding, as owing the RFC $9,500,000 more than the amount actually owing, namely, the full amount of the old bonds (with interest) surrendered to and now held by the RFC?

(a) As Between Petitioner and RFC, the Debt of Petitioner to RFC is Only the Amount of the RFC Loan.

In the main brief of appellants herein (under the heading "First Proposition"), it is, we believe, demonstrated that it would be unthinkable for any court to hold, as between the RFC and the petitioner, that the petitioner owed the RFC the face amount of the bonds held by it. It is, on the contrary, shown, we submit, that the total amount owing to the RFC by the petitioner is the amount of the RFC's advances to the district or on its behalf. We shall mention only briefly a few of the almost countless authorities which call for this conclusion.

Preliminarily, the loan contract between the RFC and the petitioner is, by its own terms, governed by California law (Ex. OO, p. 216).

In California, as elsewhere, the authorities show that, for literally a dozen reasons, the contract here involved is a pledge and not a purchase.

It is, of course, well settled that a transfer from a third party directly to the creditor has the same effect as a transfer from the debtor to the creditor so far as concerns the question whether the transfer is a purchase

and sale, or is a transfer merely as security. *Rosemead Co. v. Shipley Co.,* 207 Cal. 414, 422, and authority there cited.

It matters not, therefore, that in this case the bonds passed to the RFC, not from the District but from third persons.

The following sections of the Civil Code should be noted:

> *Sec. 2924.* Every transfer of an interest in property, other than in trust, made only as a security for the performance of another act, is to be deemed a mortgage, except when in the case of personal property it is accompanied by actual change of possession, in which case it is to be deemed a pledge. * * *
>
> *Sec. 2888.* Notwithstanding an agreement to the contrary, a lien, or a contract for a lien, transfers no title to the property subject to the lien.
>
> *Sec. 2889.* All contracts for the forfeiture of property subject to a lien, in satisfaction of the obligation secured thereby, and all contracts in restraint of the right of redemption from a lien, are void.

It is apparent from these sections alone, not to mention the authorities later discussed, that the policy embodied in these statutes applies without distinction to mortgages and pledges. For the sake of brevity, we now quote several excerpts from the article on mortgages in California Jurisprudence, which set out well-settled principles of law:

> "It is accordingly the settled policy of equity *never to permit a security to be converted by any contemporaneous agreement into a sale.*" (17 Cal. Jur. 742.)

"The only difficulty in most cases is to ascertain *whether a debt subsists* or has been extinguished, and *when there is doubt on this point* as affecting the question as to whether the instrument is a conditional sale or a mortgage, *courts of equity lean in favor of the right of redemption.*" (17 Cal. Jur. p. 742.)

"If at the time a deed is executed it is intended merely as security for a debt, it follows as a matter of law that it is a mortgage, *regardless of any intention or stipulation that it shall be something else.*" (17 Cal. Jur. p. 743.)

"That the grantee is mistaken as to the legal effect of the deed, however, does not change the rights of the parties, and the fact that he testifies that in his opinion the instrument is not a mortgage is immaterial." (17 Cal. Jur. p. 743.)

"If the transfer is in fact made as security, it is in equity a mortgage *irrespective of the form in which it is made,* and *no matter how expressly the parties may agree that it shall not be so deemed,* and no matter how strong the language of the deed or any instrument accompanying it may be. *No form of words, however adroitly used to conceal the purpose* of security can estop the grantor from pleading and proving the fact, for *it is not a matter of contract but of law.* It is the real character, not the form of the instrument, to which the court will look." (17 Cal. Jur. p. 745.)

"* * * If a consideration is a pre-existing debt or a present advance of money and *the relation of debtor and creditor remains, the conveyance must be treated in all respects as a mortgage.*" (17 Cal. Jur. pp. 783-784.)

"The fact that interest is to be paid upon the amount of money received for the deed is *very strong circumstance* tending to show that the transaction is a loan, *such obligation being inconsistent with the theory that the grantee is absolute owner.* So the fact that the grantee charged his vendor annually with interest upon the whole of the purchase money which he paid, *which interest he received year after year,* is strong evidence that the transaction was a mortgage." (17 Cal. Jur. pp. 786, 787.)

"The following circumstances tend to prove a deed to be a mortgage; payment by the grantor of charges of recordation; language in the instrument respecting 'foreclosure'; statements by the grantee in letters speaking of the property as being 'mortgaged' or 'encumbered', and an agreement giving the grantor a right to redeem." (17 Cal. Jur. pp. 795, 796.)

The following quotation is taken from the article on Pledges contained in the same treatise:

"Notwithstanding the transfer of property purports to be absolute, if made as security in truth and in fact, it may and will be held to be merely a pledge." (21 Cal. Jur. pp. 292, 293.)

The case of *Shelley v. Byers,* 73 Cal. App. 44, is a case identical in principle, we submit, with the present one. We commend it to the Court's attention.

Under the authorities above discussed, transactions like that between the RFC and petitioner are uniformly construed as contracts of loan rather than purchase on the basis of *any one* of numerous factual circumstances. As shown in the main brief of appellants herein, *all* of the

grounds taken count of by the Courts as *singly* establishing the existence of a security transaction are present in the case now before this Court.

(b) No Provision in the Statute Permits Debts That Have Been Extinguished to be Treated as Still Existing For Any Purpose.

The only provision in the Municipal Bankruptcy Act which might be even plausibly argued to be relevant to the question is the part of Section 82 reading as follows:

> "Any agency of the United States holding securities acquired pursuant to contract with any petitioner under this chapter shall be deemed a creditor in the amount of the full face value thereof." (11 U. S. C. 402.)

The only other provision which could be argued to have the effect just stated in the heading is subdivision (j) of section 83 (11 U. S. C., Sec. 403(j)). That provision is inapplicable primarily for three reasons:

(a) It is limited expressly to cases in which refunding bonds have been issued. None have been issued here.

(b) It does not purport to allow holders of the refunding bonds to vote, or otherwise act as, creditors beyond the amount of the refunding bonds held.

(c) Although it applies to refunding bonds issued before the filing of the petition, it does not purport to operate retrospectively.

We submit that the provision just quoted furnishes no authority for the contention of the petitioner. Petitioner must argue, in order to succeed in this proceeding, that

although in fact the district's debts had been reduced, by more than $9,500,000 prior to the enactment of the Municipal Bankruptcy Act, it is nevertheless to be held that those former debts are to be revived for the purposes of this proceeding; and that upon that basis, it is to be held that the district needs the relief sought because (as is contended) it cannot pay its present debts plus its former debts.

The provision will not support the contention, for the following reasons:

1. Even if applicable here, it does not so provide;

2. The provision is inapplicable, since the transaction occurred years before it was enacted. In other words, the debts of the petitioner had been reduced by a completed accord and satisfaction nearly two years before the statute was passed.

The Statute Does Not So Provide.

(a) The provision quoted does not even suggest that it is intended to dispense with the requirement that any creditor whose consent is to be taken account of must be affected by the plan. And for a creditor to be affected by the plan, the plan must be such that his "rights * * * are proposed to be adjusted or modified materially". Here, the rights of the RFC are not adjusted or modified by the plan at all, whether materially or otherwise.

(b) For the statute to operate at all, 51% (in amount) of the creditors affected by the plan must consent initially, and two-thirds must consent before the plan may be confirmed, "excluding, however [in both cases], any securities owned, held, or controlled by the petitioner." (Sec.

83 (a), 83 (d).) This language excludes pledged securities from those whose consent may be counted, since they are owned by the pledgor (petitioner), the pledgee having only a lien:

> "The general rule that notwithstanding any agreement to the contrary a lien or a contract for a lien transfers no title to the property subject to the lien, is applicable to pledges." (21 Cal. Jur. 328.)

This language is quoted and applied in

Western Mortgage etc. Co. v. Gray, 215 Cal. 191, 201;

Bank of America etc. Ass'n Figueroa, 218 Cal. 281.

See also the many cases cited in California Jurisprudence, *supra.*

(c) By Section 83 (b) of the Bankruptcy Act:

> "The holders of claims for the payment of which specific property or revenues are pledged, or which are otherwise given preference as provided by law, shall accordingly constitute a separate class or classes of creditors."

Under this provision, the RFC is in a different class of creditors from appellants, for at least two reasons:

(1) By the contract between petitioner and RFC, the petitioner pledged the revenues to be received from power,

> "in each calendar year commencing January 1, 1936 except the first $100,000 thereof and except any amount in excess of $575,000 in each such calendar year * * *"

The petitioner agreed that,

> "such allocation shall be irrevocable." (R. 209, 210).

Thus, in the language of the statute, RFC is "the holder of a claim for the payment of which specific property or revenues are pledged".

(2) As shown above, the RFC is also pledgee of $14,686,000 of old bonds to secure payment of its loan.

It is to be observed that even though the provision of the statute quoted above were given all mechanically possible effect (i. e., even though the RFC were considered to be in fact, and for all purposes, a creditor of the petitioner to the full amount of the old bonds held by it), the RFC's consent would still be inoperative against appellants, since undeniably specific revenues are pledged to it, namely, the power revenues, not to mention the old bonds.

(d) The statute (quoted above) says that any agency of the United States holding securities acquired pursuant to contract with any petitioner shall be deemed a "creditor" in the amount of the "full face value thereof." But "creditor" has a peculiar meaning as here used. It is defined in the same section of the statute as follows: "The term 'creditor' means the holder of a security or securities." (11 U. S. C., Sec. 403.)

Now a pledgee is, of course, a "holder" of the securities held in pledge. But the pledgee's status as a holder does not increase the debts of the pledgor, even though the securities held in pledge are the pledgor's own obligations.

The law on this question appears to be fairly clear. Although the transaction is anomalous, it appears to be settled that a debtor may pledge his own bonds: As se-

curity for his promise to pay $1,000, a debtor may pledge an instrument which is simply another promise by him, to pay another $1,000. When it does so, the pledgee may realize on (i.e., obtain a judgment upon) the pledged promise, in addition to obtaining a judgment on the main promise, as security for which the instrument was pledged. But the pledgee may, of course, obtain only one satisfaction, that is to say, may actually collect only the amount actually owing.

Anglo-California Trust Co. v. Oakland Railways, 193 Cal. 451;

Murphy v. Murphy, 74 Conn. 198.

In the event of bankruptcy proceedings, moreover, the only amount which the pledgee may prove is the amount owing on the actual debt.

Sauve v. Fleschutz, 219 Fed. 542;

Butterfield v. Woodman, 223 Fed. 956;

In re Sullivan Condensed Milk Co., 291 Fed. 66.

Taking account of this rule, we submit that the provision of the Municipal Bankruptcy Act under inquiry (providing that a public agency holding securities pursuant to contract with the petitioner shall be deemed a "creditor", i.e., a holder, in the amount of "the full face value thereof"), should be taken simply to codify the rule just discussed.

In other words, the provisions should be taken to mean that a public agency which makes a loan in aid of a refinancing scheme, taking the old bonds surrendered as security for its loan, shall have the remedies of any holder of bonds for the purpose of insuring repayment of its loan.

There is one other construction which might rationally be given to the provision in question. There is some authority (although it is not now generally accepted) that a pledgee of an insolvent debtor's own securities is entitled to a proportion of its assets equal to the proportion of its securities held in pledge, even though that is more than the proportion of its actual debts held by the pledgee. See *Barry v. Mo. K. & T. Ry. Co.,* 34 Fed. 829. In that case a railway company which had outstanding an issue of bonds that were a lien on income, issued general refunding mortgage bonds to take up the income bonds. Under the plan, interest on the old bonds (i.e., the income bonds) was not to be paid in full but by new bonds equal in amount to 60% of the face value of the interest coupons. Some of the old bonds were exchanged and some were not. This was a proceeding requiring the Company to account for and pay over accumulated income to the persons entitled thereto. The Court held that the holders of old income bonds who had not surrendered them were entitled only to the *same proportion* of this income as they would have been entitled to if none of the income bonds had been surrendered. The refunded old bonds had been surrendered to a trust company as trustee, and were (as we say is the case here), "held uncancelled *as security* for the new bonds."

If the provision of the Municipal Bankruptcy Act in question were given this effect, then, in the distribution of any fund of a petitioner available to creditors, the RFC would be entitled to a proportion thereof equal to the proportion of the original bonded indebtedness of petitioner represented by the old bonds held in pledge

by it. It would be so entitled, however, only up to the amount actually owing to the RFC.

Anglo-California Trust Co. v. Oakland Railways, 193 Cal. 451, and other cases cited above.

Whichever of these interpretations is adopted, it is clear that for purposes of determining whether the district needs the relief sought, the statute does not permit or require that question to be answered on the fictitious assumption that the whole amount of the district's old bonds, with interest, is still owing.

No Rational Purpose Would be Accomplished by Construing the Statute as Reviving the Cancelled Debts For Any Purpose.

The Municipal Bankruptcy Act, like the other composition sections, requires the consent of a percentage of creditors before the plan may be confirmed. We submit as unquestionable that for a "consenting" creditor to be a "creditor" capable of consenting as a member of the same class as objecting bondholders, the consenting bondholder must preserve his status as a creditor who will be affected by the plan. In other words, his consent must be conditional upon the plan's being carried out under the statute. If, instead of consenting to the plan within the meaning of the statute, a bondholder enters into an accord and satisfaction, i.e., accepts less than the amount due in full satisfaction of the debt owing to him and represented by the bond, he thereby irrevocably accepts a status different than that of other bondholders. It was so held flatly in the case of

In re City of West Palm Beach (C. C. A. 5th), 96 F. (2d) 85.

This case is precisely in point; and (we submit) is clearly sound.

The opinion therein is short and we earnestly commend it to the Court's attention. The Court said in part (p. 86):

> "* * * The owners of these were no longer acceptors of an executory plan, but had been fully settled with under it and no longer had any direct interest in it. They could not fairly be counted as voters before the court on the propriety of the plan. Of course they would wish the nonacceptors to be forced to scale their debts as they themselves had done. They could no longer have an open mind as to whether, in the light of developments, the plan was a good one or a bad one. The binding of a minority by a majority having the same interests was discussed as respects corporate reorganizations in Texas Hotel Securities Co. v. Waco Development Co., 5 Cir., 87 F. 2d 395, and Continental Ins. Co. v. Louisiana Oil Ref. Corp., 5 Cir., 89 F. 2d 333. The importance of identity of interest is there stressed. We do not think the creditors of West Palm Beach who have already irrevocably scaled their debts can be counted either in the two-thirds finally to be needed, nor as preliminary acceptors of the scaling plan offered as a composition."

We submit that no other conclusion is possible than that reached by the Court in the *West Palm Beach* case.

The fact is, and this Court may doubtless take judicial cognizance thereof, that the usual means of effecting compositions under the bankruptcy act is for consenting

creditors to consent to the plan on condition that it is carried out.

There is no difficulty for the RFC to participate in this manner. If its purpose at the time it makes a loan is to maintain the status of the surrendered bonds as those of consenting creditors within the meaning of the act, it may, and does in fact, simply postpone disbursement of the loan until a decree confirming the plan has become final. An example is the case of *Covell v. Waterford Irrigation District,* a proceeding under the first Municipal Bankruptcy Act, reported in 86 F. (2d) 52. Doubtless the records of this Court will show the fact that no disbursement was made in that case, and indeed none has yet been made.

The fact is, therefore, that no rational purpose would be served by announcing the astonishing proposition that the provision of the Municipal Bankruptcy Act quoted above has the effect that a petitioner owing $10,000,000 may scale down its debts as if it owed $20,000,000.

In Any Event, the Provision Making Public Agencies Creditors For "Full Face Value" is Inapplicable, Under the Rule Against Retrospective Interpretation.

There is, of course, a general rule that statutes are not construed as intended to be retrospective in operation unless intention that they shall so operate is unequivocally expressed. Speaking of the rule that statutes are never construed to operate retrospectively unless clearly intended, Mr. Justice Story spoke as follows in a much cited case:

"Is it confined to statutes, which are enacted to take effect from a time anterior to their passage, or does it embrace all statutes, which, though operating only from their passage, affect vested rights and past transactions? * * *

"It would be a construction utterly subversive of all the objects of the provision, to adhere to the former definition. * * * Upon principle, every statute, which takes away or impairs vested rights acquired under existing law, or creates a new obligation, imposes a new duty, or attaches a new disability in respect to transactions or considerations already past, must be deemed retrospective." (*Society v. Wheeler,* 2 Gall. C. C. 105, 139.)

This rule, of course, applies to bankruptcy statutes as to others.

Holt v. Henley, 232 U. S. 637;

Arctic Ice Machine Company v. Armstrong County Trust Co., 192 U. S. 114;

In re Shorer, 96 Fed. 90;

In re New Amsterdam Motor Co., 180 Fed. 943.

It is also, of course, well settled that where, as here, retrospective interpretation would raise grave questions of constitutionality (*Holt v. Henley,* supra) that construction will, if it is possible to do so, be avoided.

Reinecke v. Northern Trust Co., 278 U. S. 339;

Bell Telephone Co. v. Nebraska State R. Co., 297 U. S. 373;

Interstate Commerce Commission v. Oregon-Washington R. & Nav. Co., 288 U. S. 14;

George Moore Ice Cream Co. v. Rose, 289 U. S. 373.

Concluding this point we submit that the following propositions are established:

(a) Since petitioner's debt to the RFC consists only of the amount of the RFC loan, the petitioner's total debt is nearly $10,000,000 less than petitioner claims it to be.

(b) It follows that petitioner is entirely solvent and able to meet its debts as they mature. There is no contention in this case that the petitioner needs any relief unless it persuades the Court to hold that its debt to the RFC is the total amount of bonds held by that corporation ($14,686,000) with unpaid interest.

(c) That since the RFC is to receive, under the plan, every cent owing to it, that corporation is not affected by the plan.

(d) That since the RFC is to be paid in full (and has other security for payment, namely, the power revenue), it is in a different class of creditors from the nonconsenting bondholders.

In essence the district's contention amounts to this: that since some two years ago (long before the statute was passed which is the basis of this proceeding), a large number of the old bondholders of petitioner chose voluntarily and irrevocably to accept 51.501 cents on the dollar in full satisfaction of their claims, appellants should be compelled to do the same. We respectfully submit that no considerations of justice suggest any such conclusion; and certainly nothing in the statute would justify a decision to that effect.

CONCLUSION.

For the reasons above stated and for the other reasons stated in the main brief of appellants herein, we submit that the judgment of the Court below should be reversed with directions to dismiss.

Dated, San Francisco,
October 16, 1939.

Respectfully submitted,
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